IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-1800

UNITED STATES OF AMERICA,
Petitioner,

vs.

ONOFRE J. SOTELO and NAOMI SOTELO,
Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

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BRIEF FOR THE RESPONDENTS

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QUESTION PRESENTED

The respondents respectfully disagree with the statement of the question presented as set forth in the government's brief, and submit that the question presented is more properly stated as:

Whether the personal liability for the penalty assessed under Section 6672 of the Internal Revenue Code is discharged by the bankruptcy of the individual.

STATEMENT

The respondents generally agree with the statement of the case in the government's brief, with the exception of the material in footnote 2 on page 3. Respondents submit that the government's claim for unpaid corporate taxes, proved in the personal bankruptcy and allowed by the bankruptcy court, is a fact needed in the text of the statement.

SUMMARY OF ARGUMENT

The Court of Appeals for the Seventh Circuit correctly held that the personal liability imposed by Section 6672 of the Internal Revenue Code is discharged by the bankruptcy of the individual. The general bankruptcy rule provides that a "discharge shall release a bankrupt from all of his provable debts, whether allowable in the whole or in part, except such as * * *." Bankruptcy Act, Section 17(a). The obligation in this case was a debt that was proved and allowed, so presumptively it is discharged unless it can be shown to come within one of the statutory exceptions to discharge. The government argues two possible exceptions, and respondents submit that neither of them applies here.

A.

One of the exceptions to discharge is found in Section 17a(1) which bars a discharge for "taxes which became legally due and owing by the bankrupt to the United States * * *." Respondents submit that the liability for a tax in this situation is that of the bankrupt corporate employer, not Sotelo personally. The personal liability, although measured in amount by the tax unpaid by the corporation, is not itself a tax from the viewpoint of the individual debtor. The characterization of the obligation is best determined by the words of the statute imposing it, and those words clearly indicate that the personal liability is a penalty, not a tax.

B.

The other exception to discharge argued by the government is Section 17(a)(1)(e) of the Bankruptcy Act which provides that "discharge in bankruptcy shall not release a bankrupt from any taxes * * * which the bankrupt has collected or withheld from others as required by the laws of the United States * * * but has not paid over * * *." Respondents submit that it was the corporation that collected and withheld the amounts in question, and that the bankrupt, as an individual, never collected or withheld any tax as contemplated by the statute.

ARGUMENT

THE PERSONAL LIABILITY FOR THE PENALTY ASSESSED UNDER SECTION 6672 OF THE INTERNAL REVENUE CODE IS DISCHARGED BY THE BANKRUPTCY OF THE INDIVIDUAL.

A. Introduction

This case presents a question of statutory construction involving the dischargeability in bankruptcy of a personal liability for a penalty imposed under Section 6672 of the Internal Revenue Code. The answer is found by the interpretation of the relevant statutes to determine what Congress meant by the words used, since clearly Congress has the ultimate legislative power to compel either result. The respondents therefore deem it unnecessary to answer the introductory arguments of the Government concerning the alleged historical and fiscal significance of this case. The answer is in the statutes, no matter what result is reached.

There is no question that respondent Onofre J. Sotelo was personally liable for the Section 6672 penalty, and that respondent Naomi Sotelo was not liable. The government brief cites a large number of cases dealing with such questions as who is the person liable, what is meant by "willfully," and other matters not relevant to the question of discharging the penalty in bankruptcy. These cases have been collected in Appendix A, *infra*, and each tabulated as to the reason for not being applicable here. Many of these cases appear to have been cited for particular definitional dicta. Respondents submit that such definitions, drawn from cases not involving the immediate question presented, are not applicable here.

B. The Penalty Assessed Under Section 6672 Of The Internal Revenue Code Is Dischargeable In Bankruptcy.

Until the court below decided the case at bar, every reported case considering the dischargeability of the Section 6672 penalty held that it was a non-dischargeable tax. This line of cases originated with *Botta v. Scanlon*, 314 F.2d 392 (C.A.2, 1963) and all the other authorities flow from that case. The plaintiff individuals in that case sought an injunction against the Internal Revenue Service to restrain the collection of the Section 6672 penalty. The court denied the injunction on the authority of Section 7421(a) of the Internal Revenue Code, known as the Anti-Injunction Act, which provides:

> "* * * no suit for the purpose of restraining the * * * collection of any tax shall be maintained in any court * * *."

The plaintiffs argued that the liability under Section 6672 was a "penalty" and not a "tax" and therefore could be enjoined in spite of the Anti-Injunction Act. The answer to that argument is in Section 6671(a) of the Internal Revenue Code which provides:

> "* * * any reference in *this title* to "tax" imposed by *this title* shall be deemed also to refer to the *penalties* * * * provided by *this subchapter*" [emphasis supplied].

The *Botta* court therefore correctly concluded by virtue of Section 6671(a) that "penalty" was equal to "tax" *for the purpose of the Anti-Injunction Act.*

The first case to pass directly on the question of dischargeability was *Sherwood v. United States*, 228 F.Supp. 247 (U.S.D.C., E.D., N.Y., 1964). Based on *Botta*, the court in *Sherwood* concluded that the penalty was a tax, and held that it was non-dischargeable. Without any real analysis or explanation, but merely as an un-

supported conclusion, various other district courts then applied *Botta* as interpreted by *Sherwood* and held the Section 6672 penalty was non-dischargeable. Because all these later cases rest on this same line of reasoning, further discussion of them would serve no purpose.

Besides the case under consideration here. two circuit courts of appeal have passed on this question. Neither of these two decisions contains any explanation for the conclusion reached. The Fifth Circuit, by *per curiam* affirmance, adopted its district court opinion. *Murphy v. Internal Revenue Service,* 533 F.2d 941, affirming 381 F.Supp. 813. The trial judge's opinion in *Murphy* (at 815) makes this observation:

> "* * * the plight of the bankrupt is one that naturally incites sympathy and tends to provoke compassion. The purpose of bankruptcy to give the bankrupt a new start in life and to free him from the burden of his debts is frustrated by a proceeding which does not discharge him from paying taxes created by a corporate enterprise which ended in financial disaster and in his own personal financial ruin."

Despite this language, the district judge felt constrained to hold for non-dischargeability based on *Botta* and *Sherwood.*

The Fourth Circuit based its result on the district court opinion in *Murphy,* and contains no explanation for its reasoning. *Lackey v. United States,* 538 F.2d 592.

The Fourth and Fifth Circuit opinions should be compared to the complete analysis of the question presented furnished by the Seventh Circuit in this proceeding. *Sotelo v. United States,* 551 F.2d 1090 (Pet. App. C, p. 17a). The Seventh Circuit properly analyzed the improper application of *Botta* to the bankruptcy context by pointing out that there is no equivalent in the Bankruptcy Act to Section 6671(a) of the Internal Revenue Code.

The characterization of the liability by the statute itself should be controlling. Section 6672 says "penalty" and does not make the individual directly liable for a tax. While it is understandable why the government would prefer to call this obligation a tax, the best evidence of the nature of a statutory liability is what it is called in the statute creating it. Section 6672 repeatedly stresses the penalty idea by providing that the responsible party "* * * shall, in addition to the other *penalties* provided by law be liable to a *penalty* * * *. No *penalty* shall be imposed under section 6653 for any *offense* to which this section is applicable." [emphasis supplied].

A similar question was passed upon in *United States v. Childs,* 266 U.S. 304, where it was necessary to distinguish between "penalty" and "interest" on a tax claim in a bankruptcy case. The then applicable statute (quoted at 307) provided:

> "* * * there shall be added the sum of five per centum on the amount of tax unpaid and interest at the rate of one per centum per month upon said tax from the time the same becomes due."

The government conceded that the 5% addition was a penalty. The court followed (at 309) the characterization of the 1% rate as interest, saying:

> "* * * the Federal statute is precise, and is made peremptory by the distinction between 'penalty' and 'interest' * * *."

As a policy matter, the treatment of the Section 6672 penalty as non-dischargeable leads to horrendous results, especially where a large enterprise experiences a financial reversal. When a person remains liable after a personal bankruptcy for the taxes of that person there is some connection between the amount of the tax liability and the assets that were directly available to that in-

dividual at some point. This nexus is absent when an individual is held liable for the taxes owed by a corporation. The corporate liability could well exceed the present or future resources of the individual. Except for the meager exemptions provided by Section 6334 of the Internal Revenue Code, the future earnings of a hapless debtor could be confiscated forever.

We do not deny that it is within the power of Congress to create such a severe result, but such a drastic conclusion should not be created by statutory construction when a more reasonable interpretation is available. One purpose of the Bankruptcy Act is to grant debtors a fresh economic start and such purpose should be given effect here. The tax collector can take the corporate assets and go on to take the existing assets of the individual. Anything more is peonage.

C. The Bankrupt Individual In This Case Is Not A Person Who "Collected Or Withheld From Others" For The Purposes Of The Bankruptcy Act.

The basis of the decision below was not only the characterization of the obligation as a "penalty" as distinguished from "tax," but also was a recognition that the Section 6672 liability is vicarious in nature. There is no nexus between the income or property of the bankrupt and the "tax" sought to be imposed on him. To avoid this problem, the government alternatively relies on Section 17(a)(1)(e) of the Bankruptcy Act which provides:

> "* * * a discharge in bankruptcy shall not release the bankrupt for any taxes * * * which *the bankrupt has collected or withheld from others* as required by the laws of the United States * * *" [emphasis supplied]

This clause cannot be dispositive of the issue presented. Because the provision is expressly limited to "taxes," the government brief presupposes that the liability under Section 6672 is a "tax," which is the very question involved in the primary argument.

Contrary to the government's position, a literal reading of the quoted section of the Bankruptcy Act leads to the conclusion that it does not apply to the Section 6672 penalty. As stated by the Court of Appeals, "* * * it was not Sotelo himself, but his employer-corporation, that was obligated by law to collect and withhold * * *." Although Section 6672 imposes a personal liability on the individual for the purposes of the Internal Revenue Code, it does not follow that the obligation is the same for the purposes of the Bankruptcy Act.

The legislative history cited by the government is actually supportive of the conclusion that Section 17(a)(1)(e) of the Bankruptcy Act applies to *employer-bankrupts* who fail to remit withheld payroll taxes, but not to *employee-bankrupts* who are held vicariously liable under Section 6672. The committee reports cited in the government brief which deal with Section 17(a) of the Bankruptcy Act as presently in effect do not cover the Section 6672 liability. Congress and the Treasury were only concerned with taxes which were formerly not otherwise dischargeable, but which were made dischargeable by enactment of the three year limitation added to Section 17(a)(1).

The addition of Section 17(a)(1)(e) was only to prevent the discharge of three-year-old unpaid employment taxes owned by a *bankrupt-employer* and not a *bankrupt-employee.* This additional proviso was enacted in response to objections made by the Treasury to a proposal,

which became law, which permitted the discharge of taxes which were due and owing more than three years prior to bankruptcy. Reference to the Treasury's letter to the House Judiciary Committee, as reproduced in the committee report cited by the government, reveals that the Treasury was objecting to the discharge of employment taxes collected by employer-bankrupts only.

> The proposal would thus discharge * * * liabilities resulting not from the bankrupt's failure to pay *his own taxes* but from *his* failure to keep intact money which *he* had obtained from others as a *trustee* for the Government." [Emphasis supplied]. H.R. Rep. No. 2535, 85th Cong., 2d Sess. 6 (1958)

The foregoing report does not refer to the Section 6672 penalty, nor does the following:

> "Again the department is also concerned with the inequity of granting a taxpayer a discharge of *his* liability for payment of trust fund taxes which *he* has collected from *his employees* and the public in general. * * * The department does not believe that it is equitable or administratively desirable to permit *employers* and other persons who have collected money from third parties to be relieved of their obligation to account for and pay over such money * * *." [Emphasis Supplied]. H.R. Rep., No. 372, 88th Cong., 1st Sess. 6 (1963).

We suggest that the relationship between the corporation-employer, the Internal Revenue Service, and the individual corporate officer is analogous to suretyship. The dischargeability of the underlying debt, in this case taxes, is determined by the status of the principal debtor to the creditor. The dischargeability of the obligation of the surety to the creditor, however, does not depend on the nature of the underlying debt. A surety who guarantees child support payments, which are non-dischargeable by virtue of Section 17(a)(7), is entitled to be discharged. *In re Sullivan*, 262 F.574. Sureties who

guarantee fiduciary obligations, which are non-dischargeable under Section 17(a)(4), are similarly discharged. *Jones v. Knox*, 46 Ala. 53, *McMinn v. Allen*, 67 N.C. 131. The liability of a person to pay the taxes of another is dischargeable in bankruptcy. *Duffy v. Collum*, 49 Ga.App. 470, 176 S.E. 41.

The difficulty with the government's position on this issue is the attempt to transplant concepts derived from the Internal Revenue Code and implant them into the Bankruptcy Act. Each of these statutes was enacted for its own peculiar purposes and each must be interpreted in light of its own overall function. The Internal Revenue Code determines who is *liable* for what amounts, as a function of collection. The Bankruptcy Act determines what obligations are *dischargeable* as a function of relief. The creation of a liability by one law and the discharge of that same liability by another is completely harmonious to the purpose of both laws.

The various administrative policy statements cited by the government merely reflect the desire of the Internal Revenue Service to collect the Section 6672 penalty after a bankruptcy. These statements do not overcome the fundamental unfairness of holding an individual perpetually in bondage for a sum which could exceed his total lifetime receipts. Ours is a society in which risk of private capital is admired and encouraged. Although it is essential that government be financed, it is also essential that individuals be permitted to start anew if their personal fortune has been risked and lost. Imposing permanent economic servitude on the unfortunate corporate officer whose employer has failed may well be within the scope of congressional power under Article I, Section 8, of the Constitution; but such a harsh result should not be presumed in the absence of a clear statutory mandate.

CONCLUSION

Because the Government has requested further proceedings in the Court of Appeals, regardless of the decision here, we have attached a separate discussion opposing a remand to the Court of Appeals if that court's decision is affirmed. Appendix B, *infra.* The respondents submit that the judgment of the Court of Appeals for the Seventh Circuit should, in all respects, be affirmed.

Respectfully submitted,

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APPENDIX A

Tabulation of cases cited in the government brief which respondents submit are not applicable.

Page of Government Brief	Cases Cited	Respondent's Characterization
12	*Adams* v. *United States*, 504 F.2d 73	1
28	*Bob Jones University* v. *Simon*, 416 U.S. 725	3
28	*Braden* v. *United States*, 442 F.2d 342, certiorari denied *sub nom. Bonistall* v. *Braden*, 404 U.S. 912	1
24	*Bruning* v. *United States*, 376 U.S. 358	4
28	*Burden* v. *United States*, 486 F.2d 302, certiorari denied, 416 U.S. 904	2
30	*Cross* v. *United States*, 311 F.2d 90	2
11	*Dillard* v. *Patterson*, 326 F.2d 302	1
25	*Donaldson* v. *United States*, 400 U.S. 517	5
12	*Genins* v. *United States*, 489 F.2d 95	1
12	*Groman* v. *Commissioner*, 302 U.S. 82	6

Page of Government Brief	Cases Cited	Respondent's Characterization
27	*Hamar* v. *Commissioner*, 42 T.C. 867	7
11, 28, 30	*Harrington* v. *United States*, 504 F. 2d 1306	1
11, 30	*Hartman* v. *United States*, 538 F.2d 1336	1, 2
11	*High* v. *United States*, 506 F.2d 755	2
28	*Horwitz* v. *United States*, 339 F.2d 877	1
11, 32	*Kalb* v. *United States*, 505 F.2d 506, certiorari denied, 421 U.S. 979	1
32	*Larson* v. *United States*, 340 F. Supp. 1197	8
28	*Liddon* v. *United States*, 448 F.2d 509, certiorari denied, 406 U.S. 918	1
28, 30	*Monday* v. *United States*, 421 F.2d 1210, certiorari denied, 400 U.S. 821	9
11, 30	*Moore* v. *United States*, 465 F.2d 514, certiorari denied, 409 U.S. 1108	2
12, 30	*Mueller* v. *Nixon*, 470 F.2d 1348, certiorari denied, 412 U.S. 949	1
9, 27-28	*New Jersey* v. *Anderson*, 203 U.S. 483	10
11, 30	*Newsome* v. *United States*, 431 F.2d 742, certiorari denied, 411 U.S. 986	2
9, 28	*New York* v. *Feiring*, 313 U.S. 283	10
30	*Otte* v. *United States*, 419 U.S. 43	10

Page of Government Brief	Cases Cited	Respondent's Characterization
12	*Pacific National Ins. Co.* v. *United States*, 422 F.2d 26, certiorari denied, 398 U.S. 937	1
13	*Slodov* v. *United States*, certiorari granted October 3, 1977 (No. 76-1835)	1
28	*Sonzinsky* v. *United States*, 300 U.S. 506	11
30	*Sorenson* v. *United States*, 521 F.2d 325	2
30	*Spivak* v. *United States*, 370 F.2d 612, certiorari denied, 387 U.S. 980	9
28	*Teel* v. *United States*, 529 F.2d 903	2
10	*United States* v. *American Friends Service Committee*, 419 U.S. 7	12
28	*United States* v. *Butler*, 297 U.S. 1	11
16	*United States* v. *McMullen*, 516 F.2d 917	1
9, 28	*United States* v. *New York*, 315 U.S. 510	10
16	*United States* v. *Patterson*, 465 F. 2d 360, certiorari denied, 409 U.S. 1038	1
28	*United States* v. *Strebler*, 313 F.2d 402	1, 2
12	*Werner* v. *United States*, 512 F.2d 1381, affirming 374 F. Supp. 558	1
31	*White* v. *United States*, 372 F.2d 513	1, 2

Explanation of respondents' characterization of cases cited in government brief:

1. Determination of who is the responsible person under Section 6672. Such citations are not relevant here because Onofre J. Sotelo has been found to be such, and Naomi Sotelo has been exonerated.

2. Question of "willfully" as used in Section 6672. Because Onofre J. Sotelo has been held liable under Section 6672, willfulness is not an issue here.

3. Status of a claim for tax exemption unrelated to Section 6672.

4. Interest on a non-discharged debt is itself not discharged.

5. Rights of an individual in records maintained by another.

6. Corporate reorganization.

7. Certain beneficiaries of an estate are transferees who are liable for an estate tax deficiency.

8. Liability under Section 6672 does not lapse with the death of the individual.

9. Deficiency arising from a compromise with the corporation can be collected from the responsible individual.

10. Priority of a claim for distribution of assets.

11. Constitutionality of a statute determined.

12. Suit barred by Anti-Injunction Act.

APPENDIX B

Position of Respondents on Question of Remand to the Court of Appeals.

The brief for the United States correctly points out in the footnote to its conclusion that the court below did not press on the Illinois homestead question.

The respondents claimed a right of homestead in certain Illinois real estate under Smith-Hurd Ill.Ann. Stat. c. 52, Section 1 (1977 Cum. Supp.). The trustee in bankruptcy sold the property and set aside $10,000 as the Illinois statutory homestead exemption. The Internal Revenue Service later served a levy on the trustee based upon the liability of Onofre J. Sotelo under Section 6672. The question as to whether the homestead money belonged to Naomi Sotelo as the wife or Onofre J. Sotelo as the husband was presented to the bankruptcy judge, District Court, and Court of Appeals.

The Seventh Circuit did not reach homestead issue. In their view, which the respondents submit is correct, it did not matter who owned the homestead. If Naomi Sotelo is the owner, then the levy cannot reach the homestead money because she was exonerated from liability for the claim on which the levy is based. If Onofre J. Sotelo is the owner, the levy was ineffective because he was discharged in bankruptcy prior to the levy.

The Government attempts to avoid the effect of the discharge in bankruptcy, assuming that it applies, by quoting the part of Section 17(a)(1)(e) which provides that "a discharge shall not be a bar to any remedies available under applicable law to the United States or to

any State or any subdivision thereof, against the exemption of the bankrupt allowed by law and duly set apart to him under this title * * *." The quoted portion of the statute, however, must be considered in the context from which it is delivered. It is part of the list of exceptions to the general rule that bankruptcy discharges all provable debts. The proviso which makes exempt property subject to being taken applies only if the underlying liability is properly classified as a tax. This proviso was inserted to supplement the latest amendments which allow the discharge of taxes under certain specified conditions. The purpose of this provision is to permit governments to collect taxes out of otherwise exempt property, even though the tax claim itself is otherwise discharged in bankruptcy.

The result on the merits therefore determines the appropriate form of relief. If the court below is reversed, it becomes necessary to determine who owns the homestead. To the extent it is owned by Onofre J. Sotelo, the government could levy upon it; and to the extent it is owned by Naomi Sotelo, it cannot be reached by levy based on a claim solely against Onofre J. Sotelo. The respondents therefore agree that if the judgment of this court is to reverse the court below, the case must be remanded to determine the homestead ownership.

If this court holds that the obligation of Onofre J. Sotelo under Section 6672 was discharged in bankruptcy because it was not a tax on him, then the right of the Internal Revenue Service to issue a levy would end with the adjudication of bankruptcy. In that case, the ownership of the homestead is immaterial because it cannot be levied upon regardless of ownership.

The existence of this subsidiary issue further points up the need to insulate the post-bankruptcy activities of an individual from a continuing liability under Section 6672. For all practical purposes, to deny a discharge is also to forever prohibit the bankrupt from ever acquiring a home, or any other property exceeding the limitations of Section 6334 of the Internal Revenue Code. The respondents therefore respectfully repeat the conclusion that the judgment below be affirmed.